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Home Equity and Small Business Finance *

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Abstract

Entrepreneurs and small business owners rely heavily on personal investments, especially home equity. Yet, little is known about how changes in home values affect their businesses. This study uses an exogenous variation in home values in three cities in Massachusetts when—in 1995—they were forced to abandon their rent control programs, affecting home values. Using individual loan and establishment level data, we use a difference-in-difference methodology to determine how business starts, growth, performance, and survival were affected. Furthermore, we use the variation in changes of home values within these cities to identify local differences in entrepreneurial growth.

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Executive Summary

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1 Introduction

New, and small businesses, are an important source of new jobs in the US economy. Many policymakers, both political representatives and policy institutions like the Federal Reserve System, are very interested in the creation of jobs for their constituents or the US population as a whole. Thus it is important to understand exactly what drives the creation and success of these small businesses, and what barriers entrepreneurs and small business owners face.

A barrier many potential and existing entrepreneurs face is access to money to start or further grow their business. Many popular depictions of new businesses focus on the Silicon Valley, where technology start-ups vie for attention from firms who specialize in funding new companies. The firms that provide this funding are called venture capital funds, and they provide new businesses with cash in return for an ownership stake in the start-up. They expect this ownership stake will eventually be more valuable than their investment once the company is up and running. However, outside of the technology sector, venture capital is relatively rare. Most new companies, especially small family-run businesses, do not receive a large cash influx from a venture capital fund. Instead, they often rely on the personal assets of the family that owns them.

One method by which individuals can get access to money to start or grow a business is by borrowing against their homes. Banks are generally willing to make loans against home equity, because if the borrower does not pay back the loan, the bank has a procedure by which they can gain ownership of the house. This feature makes these loans less risky and therefore cheaper for the borrower than loans that are not backed by an asset. Our hypothesis in this paper is that when house values increase, people who are looking to start small businesses, but need money to do so, gain access to loans from banks that allows them to start a new business or grow an existing one.

2 Empirical Method

The difficulty in studying this topic is that it is hard to work out what causes what. If house prices rise, it is possible that this change is the result of the success of local small businesses.

If these businesses increased local incomes and economic prospects they could also have affected house prices. What we need is a change in house prices that we can reasonably infer are not due to any change in entrepreneurship and small business success. The change in house prices we use in this paper are the result of a state statute that was rescinded in Massachusetts in 1995. This state statute had allowed individual cities and towns in Massachusetts to implement rent control programs. Three cities—Cambridge, Brookline, and Boston—still had rent control programs in place when Massachusetts had a statewide vote that rescinded the state statute by a very close margin. After the vote, the rent control programs were dismantled within three months.

The properties that had been rent controlled had been poorly maintained relative to other properties. This is because they did not generate the income for the landlord they would have if they had been rented at the market rate, and could not be rented for more money, so the landlords did not have any incentive to maintain the properties as well as they maintained properties for which they could then charge a higher rent. Because of this lack of maintenance, the value of these properties fell over time, and also affected the value of properties located nearby. After rent control was removed, landlords had an incentive to quickly increase the quality of their properties, so that they could rent them out at the highest rate possible. This increased the property values of these formerly rent controlled properties, and affected the value of other buildings in the neighborhood. This change in home values is unrelated to the local business activity. It allows us to ascertain whether an increase in house prices has an effect on local businesses by comparing what happened to cities with a rent control program in 1994, by comparing business activity before and after the state statute was rescinded, and relative to cities and towns that did not have a rent control program in place in 1994.

3 Findings

We do not find any conclusive evidence that the increase in house prices due to the removal of rent control resulted in an increase home equity borrowing. There was an increase in the number of home equity loans taken out in Boston, and in Brookline there was an increase in the average size of home equity loans. However, we find no change in home equity borrowing for Cambridge, which arguably had the strongest rent control program prior to 1995 and was therefore expected to have the strongest result.

We do, however, find that there is a change in local business activity in all three cities that still had rent control programs in 1994. However, these changes are not consistent across the three cities. One city (Brookline) experienced a decrease in business activity (meaning a lower number of business establishments[1], while another (Cambridge) had an increase in in the number of establishments operating in its city and an in the number of people employed by these businesses. However, this increase in establishments and employment in Cambridge was in part focused on the high-tech sector, which are generally not the family-run types of businesses we expected to be affected. Cambridge did also experienced an increase in "churn"—both new businesses forming and failing—in the retail sector. However, since we did not find any evidence of increased home equity borrowing in Cambridge, it is difficult to know exactly how to interpret these results.

4 Conclusion

While the evidence of any increase in home equity borrowing is limited, we strongly believe more research is needed in this area. Specifically, we hope to continue this research by looking at data on self-employed individuals. All the businesses studied in this paper had at least one employee, whereas we would expect many small business to start with no employees. We are currently working to get access to this data. It would allow us to conduct a much more fine-grained analysis that would provide a more conclusive answer to how small businesses form and fund themselves.

[1] Two McDonald's locations, for example, would count as two establishments, but are part of the same firm.